Institute of Public Finance | No. 36 | Zagreb February 20, 2012 | INSTITUTE OF PUBLIC FINANCE ured@ijf.hr | www.ijf.hr TEL: +385 (0)1 4886 444

PRESS RELEASE

Does the 2012 Budget Proposal Suggest a Fiscal Policy Turnaround in Croatia?

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On 13 February, the Government adopted a 2012 Budget Proposal and Projections for 2013 and 2014[1]. After ten years, Croatia cuts its budget spending in both nominal and real terms, reducing it to the level of 2008. This is a radical fiscal policy turnaround, which should have taken place earlier.

After the temporary budget financing, which was in effect over the first three months, the Government adopted a national budget proposal and projections for 2013 and 2014. As the 2012 Budget Proposal was prepared, the average government bond yields stood at about 7.3% in January, classifying Croatia among higher-risk countries (together with Romania and Cyprus) and bringing it closer to highest-yield countries (Ireland, Hungary and Portugal). Average yields of Croatian 10-year Eurobonds increased markedly during 2011, to over 7.8%. This suggests that international markets have reservations about Croatia, expecting it to undertake concrete political actions towards fiscal consolidation. Anticipated further cuts in budget spending should certainly be a proper guarantee against an even sharper drop in credit rating that would increase government borrowing costs and surely jeopardise the Government's fiscal consolidation plans.

According to the projections, the Government expects GDP to grow by 0.8% in 2012, by 1.5% in 2013 and by as much as 2.5% in 2014. Such expectations are founded upon fiscal disburdening of the economy through contribution decreases and considerable cuts in government expenditures for employees and subsidies, but also on public investment growth.

After ten years, Croatia has a lower budget in both nominal and real terms.

Total budget expenditure are lower by HRK 3.5bn (1.5% of GDP) in 2012 relative to that in 2011, and amount to HRK 118.8bn. The most severe cuts have been made in operating expenditures (by about HRK 3.4bn, the major part of which relates to reduction expenditures for employees (HRK 1.95bn), material expenditures (HRK 213m) and subsidies (as much as HRK 933.5m). The sharpest cuts in subsidies relate to agriculture and Croatian Railways. Compensation to citizens has also been reduced (by HRK 746m). In the following two years, there will be no significant increase in expenditures for child benefits, maternity benefits and homeland war veterans' pensions. The only category to grow will be financial expenditures, dominated by expenditures for debt interest and principal repayment. These expenditures will rise from HRK 7.1bn in 2011 to HRK 7.5bn in 2012, which accounts for about 2.1% of GDP. Budget expenditures for the acquisition of non-financial assets also go down, but not as markedly as do the operating expenditures. In addition to its commitment to implement fiscal reforms aimed at reducing public expenditures, the Government is expected to launch further operational measures to restrict the rights granted by previous governments.

[1] Government of RC, 2012. *Nacrt prijedloga državnog proračuna Republike Hrvatske za 2012. godinu, s prijedlogom projekcija za 2013. i 2014. godinu*. 8th session of the Government, February 13, 2012.

Budget revenue goes up due to substantial interventions in the tax system. Operating revenue increase by HRK 1.6bn, with the largest increase expected in tax revenues, by about HRK 3.5bn. The Government is optimistic about the growth of corporate income tax revenues by about HRK 2bn (up 35% from the 2011 budget plan), and of tax on goods and services revenues by HRK 1.3bn (up 2.5%) due to an increase in the general VAT rate from 23% to 25%. The most severe cuts are planned in health insurance contribution revenues, by as much as HRK 1.9bn, as a result of reducing the contribution rate from 15% to 13%. However, there are reservations about any significant growth in corporate income tax revenues, so that the Government will have to provide a credible explanation for it. Revenues pursuant to specific regulations are expected to grow by about HRK 300m, probably due to improved collection of concession revenues.

Budget deficit goes down by about HRK 5bn from its 2011 plan and stands at about HRK 9.9bn (2.8% of GDP). This is 1.5% of GDP less than the planned 2011 deficit. The budget deficit will be mainly financed by bond issues abroad.

As shown by the financing account, total budget receipts amount to HRK 21.2bn, the bulk of which is expected to come from the sale of securities, i.e. HRK 12.7bn from bonds (bonds worth HRK 9bn are planned to be offered abroad) and HRK 2.1bn from T-bills. In addition, HRK 1.8bn is expected from credits received and about HRK 2.2bn from loans granted by international financial institutions (mostly World Bank). Another HRK 2bn for budget deficit financing in 2012 is expected from the privatisation of Croatia osiguranje insurance company and Croatian Postal Bank (HPB). In the following 2 years, privatisation receipts are expected to be about HRK 600m on average.

Total outlays for financial assets and loan repayment are planned at HRK 11.3bn. The largest shares of outlays, HRK 5.4bn and HRK 3.9bn, relate to the repayment of principal and interest on credits and loans received and for bond repayment respectively. In addition to this, outlays for guarantee reserves amount to HRK 1bn and outlays for increasing the share capital of the CBRD are about HRK 600m.

Financial account projections warn that outlays for debt repayment will grow to HRK 15.9bn and HRK 17.4bn in 2013 and 2014 respectively. This is why the Government should further insist on public spending cuts to improve its credibility and obtain more favourable terms of borrowing based on a new bond issue worth HRK 17.3bn, mostly on foreign markets (HRK 12.1bn on average). Should spending cuts not be continued, the borrowing costs could escalate, which would negatively affect the financial stability of the public finance.

It should be noted that the *central government budget deficit* narrows to 2.8% of GDP in 2012, and to 2.5% and 1.9% of GDP in 2013 and 2014 respectively. This also includes the extra-budgetary users' and local government units' deficits of 0.2% of GDP each. Due to an increase in these entities' deficits, the government has raised the limit on local government units' borrowing from 2.3% to 2.5% of their operating revenues. The *general government deficit* stands at 3.3% of GDP, down about 1.6% from the 2011 plan. The government announces further cuts in general government deficit to 3% and 2.3% of GDP in 2013 and 2014 respectively. The general government budget deficit according to the ESA methodology (including the calculated liabilities), will be 3.8% of GDP in 2012, and is not expected to decline below 3% before 2014.

The Act on the Execution of the 2012 State Budget provides that public debt may never exceed 55% of GDP. Compliance with this limit depends heavily on the restructuring of public companies, especially those from the shipbuilding sector. However, the feasibility of the Budget Proposal and deficit projections, as well as the likelihood of compliance with the public debt limit will be much easier to assess after the Government reviews and submits for parliamentary discussion the *Reports on the Operation of Companies of Special State Interest* for 2010 and 2011.